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## Gain for Insolvent Taxpayers

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## GAIN FOR INSOLVENT TAXPAYERS

— by Neil E. Harl\*

A 1995 decision by the Eighth Circuit Court of Appeals<sup>1</sup> has dramatized once again that there is relief from discharge of indebtedness income<sup>2</sup> but there is no relief from gain triggered on property transferred in settlement of debt obligations. That is the outcome even for insolvent taxpayers.<sup>3</sup>

### Gehl v. Commissioner

In the 1995 case, *Gehl v. Commissioner*,<sup>4</sup> the taxpayers borrowed funds from the Production Credit Association of the Midlands (PCA) and gave a mortgage on a 218-acre family farm. At a time when the taxpayers were insolvent, a total of 201 acres in two transactions plus \$6,123 in cash were conveyed to PCA in satisfaction of the debt. The land had a fair market value of \$116,725 and an income tax basis of \$46,384. PCA forgave the remaining balance on the loan, an amount of \$29,412.

The Internal Revenue Service, on audit, determined that the difference between the income tax basis and the fair market value of the land conveyed to PCA was reportable as gain. The taxpayers argued that any gain on the transfer should not be reportable as income because they were insolvent. The Tax Court agreed with IRS<sup>5</sup> with that decision upheld on appeal.<sup>6</sup>

### Calculating gain and discharge of indebtedness income

The income tax consequences on the transfer of property in satisfaction of recourse debt are well settled.

- The difference between the income tax basis of the property conveyed and its fair market value is gain or loss.<sup>7</sup> The amount is gain if the difference is positive, loss if it is negative. Any loss is an ordinary loss if the property was used in a trade or business;<sup>8</sup> The loss is treated as a capital loss if the property is a capital asset.<sup>9</sup> In general, a long term cash rent lease is likely to produce a capital loss<sup>10</sup> although trade or business status may continue for a period of time if property used in a trade or business is rented under a passive arrangement.<sup>11</sup>

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- The difference between the fair market value of the property transferred to the creditor and the amount of debt discharged is properly treated as discharge of indebtedness income.<sup>12</sup> If indebtedness is cancelled or forgiven, the general rule is that the amount cancelled or forgiven must be included in gross income.<sup>13</sup>

This result can be portrayed graphically as follows:

	Debt—\$152,260 (less cash paid)
Discharge of indebtedness {	
FMV—	\$116,725
Gain {	
Basis—	\$46,384
Not taxable {	
	0—

However, amounts of discharge of indebtedness need not be reported into income if the debtor is insolvent<sup>14</sup> or in bankruptcy.<sup>15</sup> Moreover, discharge of indebtedness is not includible in income if the transaction is a purchase price reduction.<sup>16</sup> Although, in general, discharge of indebtedness produces reportable income for solvent taxpayers, special exceptions have been created for solvent farm debtors<sup>17</sup> and for real property business debt.<sup>18</sup>

### Special rule for nonrecourse debt

For non recourse debt, by contrast, the fair market value of the property is ignored; the entire difference between the income tax basis of the property transferred and the amount of debt cancelled or forgiven is treated as gain or loss.<sup>19</sup>

### FOOTNOTES

1 *Gehl v. Comm'r*, 95-1 U.S.T.C. ¶ 50,191 (8th Cir. 1995) (decision designated as "not for publication"). See generally 4 Harl, *Agricultural Law* § 39.05 (1995); Harl, *Agricultural Law Manual* § 4.02[13] (1995).

2 See I.R.C. § 108.

3 *Gehl v. Comm'r*, *supra* n. 1.

4 *Id.*

5 *Gehl v. Comm'r*, 102 T.C. 784 (1994).

6 See n. 1 *supra*.

7 See Treas. Reg. § 1.1001-2(c), Example 8; Rev. Rul. 90-16, 1990-1 C.B. 12; *Jennings v. United States*, 90-1 U.S.

- Tax Cas. (CCH) ¶ 50,090 (D. Minn. 1990) (conveyance of farm to bank).
- <sup>8</sup> I.R.C. § 1231. See, e.g., *Good v. Comm'r*, 16 T.C. 906 (1952), *acq.*, 1951-2 C.B. 2 (unimproved land rented for pasture used in trade or business because of consistent attempts by taxpayer to rent land).
- <sup>9</sup> I.R.C. § 1221.
- <sup>10</sup> Ltr. Rul. 8350008, Aug. 23, 1983 (mere rental of real property does not constitute trade or business under I.R.C. § 1231).
- <sup>11</sup> See, e.g., *Wofac Corp. v. United States*, 269 F. Supp. 654 (D. N.J. 1976) (business discontinued because of unprofitability; non capital asset status not lost immediately).
- <sup>12</sup> See *Bressi v. Comm'r*, T.C. Memo. 1991-651 (capital gains income as to excess of fair market value over basis; discharge of indebtedness income for indebtedness discharged over fair market value).

- <sup>13</sup> I.R.C. § 61(a)(12).
- <sup>14</sup> I.R.C. § 108(a)(1)(B).
- <sup>15</sup> I.R.C. § 108(a)(1)(A).
- <sup>16</sup> I.R.C. § 108(e)(5).
- <sup>17</sup> I.R.C. § 108(g). See Harl, Neil E., "Meeting the Tests for the Solvent Farm Debtor Rule," 5 *Agric. L. Dig.* 153 (1994).
- <sup>18</sup> I.R.C. § 108(c).
- <sup>19</sup> See *Tufts v. Comm'r*, 461 U.S. 300 (1983); *Estate of Newman v. Comm'r*, T.C. Memo. 1990-230; Rev. Rul. 82-202, 1982-2 C.B. 36; Ltr. Rul. 9302001, Aug. 31, 1992 (difference between property basis and debt is gain; no discharge of indebtedness income). Compare *Fulton Gold Corp. v. Comm'r*, 31 B.T.A. 519 (1934) (reduction in non recourse debt results only in basis reduction, not in immediate taxation).

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## CASES, REGULATIONS AND STATUTES

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by Robert P. Achenbach, Jr.

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### ADVERSE POSSESSION

**POSSESSION.** The disputed property was included in the titles of both parties. The disputed property was a wooded marsh area at the rear of the defendants' residences and the defendants used the disputed area occasionally for hunting and trapping. The plaintiff had the property surveyed in 1960 and had placed stone markers on the corners and wood stakes along the disputed line. The plaintiff had granted hunting and trapping leases and continually inspected the property and the boundary markers. The plaintiff also dug trenasses (shallow ditches) in the disputed property and maintained the trenasses. The court held that the defendant failed to prove continuous possession of the disputed property during the previous ten years sufficient to claim the disputed property by acquisitive prescription (adverse possession). **Harry Bourg Corp. v. Punch, 653 (La. Ct. App. 1995).**

### BANKRUPTCY

#### GENERAL-ALM § 13.03.\*

**DISCHARGE.** The debtor was a wheat farmer who had borrowed operating funds from the FmHA over several years. The debtor had granted the FmHA a security interest in all crops grown on the debtor's farm and the FmHA had perfected the security interest. The debtor sought a bank loan for planting costs for the 1992 wheat crop but the bank required a subordination of the FmHA security interest in the crop which the FmHA refused to grant. The debtor then borrowed the funds from the debtor's father. In order to pay off that loan and to cover the harvesting costs, the debtor leased the land to the father who hired the debtor to harvest the crop. The debtor assigned to the father a contract to purchase the crop from a third party. Neither the debtor nor the father paid any of the proceeds of the crop to the FmHA. The FmHA sought to have its claim considered

nondischargeable to the extent the proceeds of the 1992 crop were not paid to the FmHA. The court held that the assignment and sale of the contract to third parties without payment to the FmHA when the debtor knew that the FmHA had the priority security interest in the crop was a willful conversion of the crop with the intent to harm the FmHA; therefore, the FmHA debt was nondischargeable to the extent of the sale proceeds of the crop. **In re Recker, 180 B.R. 540 (E.D. Mo. 1995).**

#### EXEMPTIONS

**HOMESTEAD.** Before filing for bankruptcy, the debtor transferred title to the debtor's residence to a trust for the benefit of an heir. At the time of the petition, the debtor continued to reside in the house and paid all maintenance expenses, taxes and insurance on the property and continued to pay the mortgage on the property. The debtor claimed the house as an exempt homestead. The court held that the transfer of title to the trust removed the homestead nature of the property and denied the exemption. **In re Robinson, 180 B.R. 174 (Bankr. E.D. Tex. 1995).**

**IRA.** The debtor claimed stock held in an IRA as exempt under Wash. Rev. Code. § 6.15.020. The trustee objected to the exemption, arguing that the state law was preempted by ERISA. The court held that ERISA did not preempt the state law exemption for IRAs. **In re Nelson, 180 B.R. 584 (Bankr. 9th Cir. 1995).**

#### CHAPTER 12-ALM § 13.03[8].\*

**DISMISSAL.** When the mortgagee attempted to foreclose on the debtor's farm land in 1987, the debtor filed for Chapter 12, but the case was dismissed when the debtor defaulted on plan payments of administrative costs and property taxes. The creditor again attempted foreclosure but the debtor refiled for Chapter 12 just before the foreclosure sale. The second case was also dismissed because the court found that the debtor could not successfully reorganize and